Economic Commentary

March 12 2025

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Economics

Bank of Canada cuts to 2.75 per cent as solid economy meets tariff uncertainty

The Bank of Canada cut its policy rate in alignment with broader market expectations as it adapted to the uncertainty of tariffs on the economy even as economic trends and inflation remained steady. In an undoubtedly difficult decision, the Bank reduced the target for the overnight rate by a quarter point to 2.75 per cent, with the bank rate at 3 per cent and a deposit rate at 2.7 per cent. We had called a hold given the firm backdrop.

While markets were right in the call for a cut, the statement highlighted the competing factors muddying the waters for monetary policy. The Canadian economy as we have noted, has come in strong, including GDP growth in Q4, and inflation has been steady and held back in part by temporary factors including the GST/HST-tax holiday. However, there tariff uncertainty is weighing, which looks to be slowing U.S. economic growth, while expected to boost Canadian inflation pressure.

On the Canadian economic front, the Bank noted that economic growth has been stronger than expected in recent quarters due to previous interest rate cuts, the Bank anticipates a slowing of growth due to the deepening trade dispute. This is already being observed through business investment channels, while softening domestic demand has been offset by export growth as U.S. firms front-load imports in advance of tariffs. The statement noted that the labour market is showing signs of slowing.

On the inflation front, the Bank noted that price growth remains steady near 2 per cent but is expected to pick up as the GST/HST tax holiday ends. It tempered this statement with the upside pressure on headline inflation from shelter costs. Short-term inflation expectations have risen due to tariff uncertainty.

While the data has leaned against a cut, economic uncertainty prevailed at this meeting with the Bank putting more weight on the economic risks, and declining consumer and business sentiment impacts on demand and investment. At the same time, it re-iterated that there will be competing factors going forward from a trade war, including a weaker economy and upward inflation pressures. The Bank has noted that it cannot offset the impacts of a trade war, pointing to limited cuts going forward, contingent on inflation and inflation expectations. We expect further economic weakness to push the Bank to reduce the policy rate to two per cent.

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